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Tax Law Notes

The Taxpayer Relief Act of 1997 And What It Got Us

The Taxpayer Relief Act of 1997¹ could easily be called the Tax Complication Act of 1997. This legislation modifies over 800 sections of the Internal Revenue Code and adds over 250 new sections. Although tax relief is provided by this legislation, it is targeted tax relief. The primary beneficiaries are homeowners, investors, families with children, and families with members who are seeking higher education.

Despite the widespread interest in the new tax legislation, most of the tax relief is not provided until next year. This year, the only relief that most taxpayers will see is a cut in the capital gains rate and the exclusion of gain on the sale of a principal residence. Taxpayers will only get this relief if their capital gains or the sale on their principal residence occurred after 6 May 1997. This note contains a review of some of the more important changes that will impact military personnel.

Sale of Principal Residence

Since members of the military are very mobile, probably one of the more significant benefits contained in the Taxpayer Relief Act of 1997 is the exclusion of gain on the sale of a principal residence.² A taxpayer can now exclude up to \$250,000 in gain (\$500,000, if a joint return is filed) on the sale of his principal residence.³ To qualify for this exclusion, the taxpayer must have owned and lived in the home for at least two of the last five years, and the sale must have occurred after 6 May 1997.⁴

If a taxpayer sold his home between 7 May 1997 and 5 August 1997, the taxpayer may elect to take this exclusion or to roll over the gain on the sale of his home.⁵ Since a roll-over of the gain would only make sense when the gain on the sale of a home exceeds \$250,000 (\$500,000 in the case of a joint return), most military taxpayers who sold their homes between these dates will choose to take advantage of the exclusion. If a taxpayer sold his home after 4 August 1997, the taxpayer must use the exclusion.⁶ Section 1034, which permitted a taxpayer to roll over the gain from the sale of a home, was repealed as of 5 August 1997.⁷

Although Section 1034 has been repealed, the repeal of this roll-over provision was not retroactive.⁸ Thus, a taxpayer who sold his home before 7 May 1997 may still roll over the gain into a new principal residence to avoid paying taxes on that gain. The taxpayer must roll over the gain from the sale of the home within the roll-over period, which is generally two years.⁹ This two-year roll-over period is suspended for up to two years while a taxpayer serves on active duty.¹⁰ As a result, active duty service members usually have four years to roll over the gain on

1. Pub. L. No. 105-34, 111 Stat. 788 (codified in scattered sections of 26 U.S.C.).

2. *Id.* § 312, 111 Stat. at 836 (codified at I.R.C. § 121).

3. *Id.* (codified at I.R.C. § 121(b)).

4. *Id.* (codified at I.R.C. § 121(a)).

5. *Id.* (codified at I.R.C. § 121).

6. *Id.*

7. *Id.* at 839 (codified at I.R.C. § 1034(b)).

8. *Id.*

9. I.R.C. § 1034(a) (West 1997).

10. *Id.* § 1034(h)(1).

the sale of their homes. The two-year roll over-period is also suspended while a taxpayer is serving overseas; however, in no case will the total period of suspension go beyond eight years from the sale of the home.¹¹

Once a taxpayer rolls over his gain into a new residence, the taxpayer will be able to take advantage of the new exclusion upon the sale of his new home. In fact, the period that he owned the old home automatically counts towards the two years required to own his home under this principal residence exclusion provision.¹² For example, if a taxpayer owned a home for three years, sold it at a gain, and purchased a new home within the roll-over period, he is considered to have owned and occupied the new home for three years. As a result, if he were to sell it one year later, he would have owned and occupied the home for four years for tax purposes and be able to exclude up to \$250,000 (or \$500,000 if a joint return is filed).

As a general rule, taxpayers will only be able to take advantage of this new exclusion once every two years. This makes sense in light of the fact that taxpayers are required to have owned and to have occupied the property for two years in order for it to qualify as their principal residence. There are some exceptions to this rule which are potentially important to military taxpayers. If a taxpayer has to sell because of "a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances," the taxpayer may exclude a pro rata share of the gain, even if he has not lived in the home for two years.¹³ Since the legislation was only recently enacted, there are currently no regulations in this area. Nonetheless, taxpayers can clearly take advantage of this exclusion more often than once every two years if they move because of a change in place of employment. If a taxpayer takes this exclusion more than once every two years, the amount of the exclusion will be prorated.

Another change in the rules governing the sale of a principal residence may benefit divorcing spouses. Previously, the spouse who left the home was often unable to roll over the gain. Since the taxpayer no longer lived in the home, the home did not qualify as his principal residence. A new code section governing the exclusion of gain on the sale of a principal residence treats the absent spouse as having lived in the house for pur-

poses of the exclusion so long as the remaining spouse was granted the use of the property pursuant to a divorce or separation instrument.¹⁴ A written separation agreement qualifies as a separation instrument.

Despite the new exclusion, taxpayers must still recognize gain to the extent of any depreciation taken for the rental or other business use of the property, but only for periods after 6 May 1997.¹⁵ Some tax savings are available in this area. For example, if a taxpayer has rented property for a period of time, he could move back into the home, live in it for two years, and exclude all of the gain except the gain related to depreciation taken after 6 May 1997. Further, a taxpayer who is currently renting property could sell that property and would be able to exclude all of the gain except for the depreciation taken after 6 May 1997, so long as the taxpayer lived in the home for at least two of the past five years.

Reduction in Capital Gains Rate

The other major provision of the Tax Relief Act of 1997 that takes effect this year is the cut in the capital gains rate. The capital gains rate is reduced for certain capital gains occurring after 6 May 1997.¹⁶

The new rate structure is more complicated. If property has been held for more than eighteen months and is sold after 6 May 1997, the capital gains rate is twenty percent.¹⁷ The twenty percent rate also applies to property that was sold between 6 May 1997 and 29 July 1997, if the property had been held more than twelve months.

The eighteen-month holding period is the result of a rather complex set of rules. Long-term capital gain continues to be defined as property held over twelve months. Net capital gain, which was formerly the gain to which the maximum capital gains rate applied, continues to be defined as net long-term capital gain minus short-term capital losses.¹⁸ As a result, the new maximum capital gains rate applies to "adjusted net capital gain," which is defined as net capital gain excluding, among other items, mid-term capital gain.¹⁹ Mid-term capital gain is defined as gain from assets held more than twelve months, but

11. *Id.* § 1034(h)(2).

12. Pub. L. No. 105-34, 111 Stat. 788, 839 (codified at I.R.C. § 121(g)).

13. *Id.* at 837 (codified at I.R.C. § 121(c)(2)(B)).

14. *Id.* (codified at I.R.C. § 121(a)(3)).

15. *Id.* at 838 (codified at I.R.C. § 121(a)(6)).

16. *Id.* § 311, 111 Stat. at 831 (codified at I.R.C. § 1(h)).

17. *Id.* at 832 (codified at I.R.C. § 1(h)(1)(E)).

18. I.R.C. § 1222(11) (West 1997).

no longer than eighteen months.²⁰ This convoluted system was necessary to ensure that the old maximum capital gains rate of twenty-eight percent continues to apply to assets held more than twelve months, but not more than eighteen months.

The current twenty-eight percent capital gains rate will continue to apply to sales before 7 May 1997 and after 28 July 1997 for property that is held for more than twelve months, but less than eighteen months.²¹ The twenty-eight percent rate will also apply to the sales of collectibles held over twelve months.²²

A maximum capital gains rate of ten percent may apply to certain taxpayers who are in the fifteen percent tax bracket.²³ Again, they must hold the asset for over eighteen months. Another rate of twenty-five percent will apply to real estate recapture that is treated as capital gain.²⁴ Finally, the maximum capital gain rate will be reduced to eighteen percent for property purchased after 31 December 2000 and held more than five years at the time of sale.²⁵ Thus, the new eighteen percent rate will not take effect until at least 2005.

Individual Retirement Accounts (IRAs)

In the area of Individual Retirement Accounts (IRAs), Congress enacted significant changes that will become effective in 1998. Several improvements have been made to the "old" IRAs.²⁶ First, Congress improved the ability to deduct contributions to these IRAs by increasing the phase-out dollar limitations. Since all active duty military personnel are covered by a pension, active duty service members will directly benefit from this change. Previously, married taxpayers filing a joint return faced a phase-out of the amount of a deductible contribution to an IRA beginning at \$40,000 and were not able to make a deductible contribution when their adjusted gross income exceeded \$50,000 (for single taxpayers, the phase-out was from \$25,000 to \$35,000).²⁷ Beginning in 1998, the new law will increase the upper limit of the phase-out from \$50,000 to \$60,000 (for single taxpayers, the phase-out will be from \$30,000 to \$40,000).²⁸ The result is that more active duty service members will be able to make deductible IRA contributions.

Second, a taxpayer is no longer treated as being covered by a pension plan simply because his spouse is covered.²⁹ The result is that a military spouse is no longer subject to the phase-out limitations so long as: (1) the military spouse is not covered by a pension plan and (2) the couple's combined income is less than \$150,000.³⁰ Thus, many active duty service members who file joint returns with their spouses will be able to make a \$2,000 deductible contribution to a spousal IRA, even though they cannot make one themselves because they are subject to the phase-out rules above.

Another change is that taxpayers can make penalty-free IRA withdrawals so long as the money is withdrawn for qualified higher education expenses.³¹ For purposes of IRA deductions, qualified higher education expenses include tuition, fees, books, supplies, and equipment for attendance at institutions of higher learning for the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer.³²

Withdrawals from IRAs can also be made without penalty so long as the money is used to purchase a first home.³³ The home must be purchased within 120 days of the withdrawal of funds from the IRA.³⁴ A taxpayer can withdraw only \$10,000 during his life and still be able to avoid the ten percent early withdrawal penalty.

Roth IRAs

Another major change in the area of IRAs is the creation of the Roth IRA,³⁵ a completely new type of IRA. Contributions to Roth IRAs are limited to \$2,000 per taxpayer per year, and the contributions are not deductible.³⁶ The principal advantage of a Roth IRA is that qualified withdrawals are not subject to any tax at all.³⁷ This is a significant advantage over the old IRAs, especially if the taxpayer earns too much to be able to make a deductible contribution to a regular IRA.

A distribution from a Roth IRA will not be treated as a qualified distribution unless the distribution is made at least five years after the taxpayer makes his first contribution to a Roth

19. Pub. L. No. 105-34, § 311, 111 Stat. 788, 833 (codified at I.R.C. § 1(h)(4)).

20. *Id.* (codified at I.R.C. § 1(h)(8)).

21. *Id.* at 832 (codified at I.R.C. § 1(h)(1)(c)).

22. *Id.* at 833 (codified at I.R.C. § 1(h)(41)).

23. *Id.* at 832 (codified at I.R.C. § 1(h)(D)).

24. *Id.* (codified at I.R.C. § 1(h)(B)).

25. *Id.* (codified at I.R.C. § 1(h)(2)).

26. *Id.* § 301, 111 Stat. at 824 (codified at I.R.C. § 219).

27. I.R.C. § 219(g) (West 1997).

IRA.³⁸ Provided that the taxpayer meets this requirement, “qualified distributions” are distributions made: after the taxpayer has reached age fifty-nine and a half; to beneficiaries as a result of the death of the taxpayer; to the taxpayer when the taxpayer is disabled; or other special purpose distributions.³⁹ Special purpose distributions are distributions that are made for

a first-time home purchase, but they do not include distributions made to pay expenses for higher education.⁴⁰

Taxpayers are limited to total contributions of \$2000 to all their IRAs each year.⁴¹ Thus, the total amount of contributions to both regular IRAs and Roth IRAs cannot exceed \$2000 for any year. However, taxpayers can mix their contributions

28. Pub. L. No. 105-34, § 301, 111 Stat. at 824. The phase-out amount will increase each year over the next nine years. The applicable dollar amount is the amount at which the phase out begins. The phase-out range is over \$10,000; however, the phase-out range for joint returns is scheduled to increase to \$20,000 in 2007. The applicable amounts each year are as follows:

(i) In the case of a taxpayer filing a joint return:

For taxable years beginning in:	The applicable dollar amount is:
1998	\$50,000
1999	\$51,000
2000	\$52,000
2001	\$53,000
2002	\$54,000
2003	\$60,000
2004	\$65,000
2005	\$70,000
2006	\$75,000
2007 and thereafter	\$80,000

(ii) In the case of any other taxpayer (other than a married individual filing a separate return):

For taxable years beginning in:	The applicable dollar amount is:
1998	\$30,000
1999	\$31,000
2000	\$32,000
2001	\$33,000
2002	\$34,000
2003	\$40,000
2004	\$45,000
2005 and thereafter	\$50,000

Id. at 824-25.

29. *Id.* at 825 (codified at 26 U.S.C. § 219).

30. *Id.*

31. *Id.* § 203, 111 Stat. at 809 (codified at 26 U.S.C. § 72(t)(2)(E)).

32. *Id.*

33. *Id.* § 303, 111 Stat. at 829 (codified at 26 U.S.C. § 72(t)(2)(F)).

34. *Id.* at 830.

35. *Id.* § 302, 111 Stat. at 825 (codified at I.R.C. § 408A).

36. *Id.* at 826 (codified at I.R.C. § 408A(c)).

37. *Id.* at 827 (codified at I.R.C. § 408A(d)).

38. *Id.* (codified at I.R.C. § 408A(d)(2)(B)).

39. *Id.* (codified at I.R.C. § 408A(d)(2)(A)).

40. *Id.* at 828 (codified at I.R.C. § 408A(d)(3)(E)(5)).

between the two types of IRAs. For example, a taxpayer who can make a \$1000 deductible contribution to a regular IRA would probably be best advised to make that contribution and also contribute \$1000 to a Roth IRA.

Taxpayers can also roll over funds currently in a regular IRA to a Roth IRA, provided that their adjusted gross income does not exceed \$100,000.⁴² Careful planning is necessary to determine whether this would be advantageous for a client. Taxpayers who elect to roll over their regular IRAs into a Roth IRA will have to pay income taxes for the amount in the regular IRA that is attributable to deductible IRA contributions and to growth as a result of earnings.⁴³ Taxpayers who roll over their regular IRAs into Roth IRAs in 1998 can include this income in their gross income over a period of four years.⁴⁴

Taxpayers cannot make a contribution to a Roth IRA if their income exceeds certain limits. Taxpayers who file a joint return will have their ability to contribute to a Roth IRA phased out when their adjusted gross income is between \$150,000 and \$160,000.⁴⁵ They will not be able to make any contribution to a Roth IRA when their adjusted gross income exceeds \$160,000. Single taxpayers will be phased out from \$95,000 to \$110,000 and will not be able to make a contribution to a Roth IRA when their income exceeds \$110,000. A married taxpayer filing a separate return will be phased out from \$0 to \$15,000 and will not be able to contribute to a Roth IRA when his income exceeds \$15,000.

Educational IRAs

A final change in the area of IRAs is the creation of educational IRAs.⁴⁶ A taxpayer can contribute up to \$500 per year to

an educational IRA, and the money in the IRA will grow tax free.⁴⁷ The distributions from the IRA will not be included in the gross income of the recipient so long as the money is used for qualified educational expenses.⁴⁸ If distributions are not used for qualified educational expenses, the distribution will be subject to income tax in the same manner as regular IRAs and will also be subject to a ten percent penalty.⁴⁹ A single taxpayer's ability to contribute to an educational IRA is phased out when his modified adjusted gross income (MAGI) exceeds \$95,000, and he cannot contribute when his MAGI exceeds \$110,000. In the case of a joint return, the ability to contribute is phased out when the taxpayers' MAGI exceeds \$150,000, and they cannot contribute when their MAGI exceeds \$160,000.

Child Tax Credit

The Taxpayer Relief Act of 1997 adds a new credit, called the child tax credit.⁵⁰ The child tax credit will be \$400 in 1998 and will increase to \$500 thereafter.⁵¹ In order to qualify for the child tax credit, a taxpayer must first have a qualifying child. A qualifying child is defined as a child the taxpayer can claim as a dependent; who has not attained the age of seventeen as of the close of the calendar year; and is either a son or daughter (or a descendant of either), stepson, stepdaughter, or an eligible foster child of the taxpayer.⁵² Note further that the child must be a U.S. citizen or a resident of the United States.⁵³

The credit is phased out when a taxpayer's MAGI exceeds certain levels. The ability to take this credit begins to be phased out at \$110,000 for joint returns, \$75,000 for single and head of household returns, and \$55,000 for married filing separately returns.⁵⁴ The credit is reduced by \$50 for each \$1000 by which

41. *Id.* at 826 (codified at I.R.C. § 408A(c)(2)).

42. *Id.* (codified at I.R.C. § 408A(c)(3)(B)).

43. *Id.* at 827 (codified at I.R.C. § 408A(d)(3)(A)).

44. *Id.* at 828 (codified at I.R.C. § 408A(d)(3)(A)(iii)).

45. *Id.* at 826 (codified at I.R.C. § 408A(c)(3)(C)).

46. *Id.* § 213, 111 Stat. at 813 (codified at I.R.C. § 530).

47. *Id.*

48. *Id.* at 814 (codified at I.R.C. § 530(d)(2)).

49. *Id.* (codified at I.R.C. § 530(d)(1)).

50. *Id.* at 796 (codified at I.R.C. § 24).

51. *Id.* (codified at I.R.C. § 24(a)).

52. *Id.* at 797 (codified at I.R.C. § 24(c)(1)(C)).

53. *Id.* (codified at I.R.C. § 24(c)(2)).

54. *Id.* (codified at I.R.C. § 24(b)(2)).

the taxpayer's MAGI exceeds the above amounts.⁵⁵ Thus, a married couple with one child and an MAGI of \$111,000 would have their credit reduced by \$50, i.e., from \$400 to \$350. For example, in 1998 (when the credit is \$400), they would lose their ability to take this credit when their MAGI exceeds \$118,000. After 1998 (when the credit is \$500), they will lose their ability to take this credit once their MAGI exceeds \$120,000. In contrast, if the couple had three children in 1998 (with a total credit of \$1,200) the credit would not be completely phased out until their MAGI exceeded \$134,000.

For most taxpayers, this credit is not a refundable credit.⁵⁶ That is, it can reduce a taxpayer's income tax to zero, but it cannot result in a refund. Taxpayers who have three or more children or who are eligible for the earned income credit may be able to qualify for a credit above this amount. The amount of the refundable credit will equal the greater of: (1) the credit allowed without regard to the nonrefundable limitation or (2) taxable income, increased by the amount of social security taxes paid, but reduced by certain other tax credits, to include part of the earned income credit. Those who are confused by this are not alone. The amount of credit allowed in these circumstances will have to be determined by reference to IRS worksheets and charts.

Education Incentives

In addition to the previously mentioned educational IRA, several new educational incentives are included in the new law. Taxpayers who have children in college have several different credits and deductions of which they may be able to take advantage. The Hope Scholarship Credit⁵⁷ and the Lifetime Scholarship Credit⁵⁸ can potentially result in a taxpayer taking a total credit of up to \$2000. This credit is not available for taxpayers who are married and filing separate returns. The Hope Scholarship Credit is not available until 1 January 1998, and the Life-

time learning credit is only available for expenses paid after 30 June 1998 for education furnished after such date.

The Hope Scholarship Credit is a credit for the amount of money spent on tuition and related expenses. The credit can be as much as \$2000 per student. The credit consists of one hundred percent of the first \$1000 spent on tuition and related expenses and fifty percent of the next \$2000 so spent.⁵⁹ The Hope Scholarship Credit is only allowed for tuition and related expenses incurred in the first two years of post-secondary education.⁶⁰ The credit is not available if the student has been convicted of a federal or state felony offense involving the possession or distribution of a controlled substance.⁶¹

The Lifetime Learning Credit is a credit equal to twenty percent of the qualified tuition and related expenses that do not exceed \$5000; thus, the maximum credit is \$1000.⁶² This \$5000 limit is scheduled to increase to \$10,000 beginning after 1 January 2003, at which time the maximum credit will be \$2000.⁶³ Unlike the Hope Scholarship Credit, this credit is available to any taxpayer for any year.⁶⁴ As a result, this credit is available during the third and fourth years of an individual's college education. Also, anyone can take additional courses and qualify for this credit so long as the courses are taken at qualified educational institutions.

Qualified tuition and related expenses include the tuition and fees required for the attendance of the taxpayer, spouse, or dependent at a qualified educational institution.⁶⁵ Qualified tuition and expenses do not include student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.⁶⁶ The amount of qualified tuition and related expenses are also reduced by any scholarships that the student may have; any education assistance allowance that the student may receive; or any payment other than a gift, bequest, devise, or inheritance that is excluded from the student's gross income.⁶⁷

55. *Id.* (codified at I.R.C. § 24(b)(1)).

56. *See* I.R.C. § 26 (West 1997).

57. Pub. L. No. 105-34, 111 Stat. 788, 799 (codified at I.R.C. § 25A(b)).

58. *Id.* (codified at I.R.C. § 25A(c)).

59. *Id.* at 800 (codified at I.R.C. § 25A(b)(1)).

60. *Id.* (codified at I.R.C. § 25A(b)(2)(A)).

61. *Id.* (codified at I.R.C. § 25A(b)(2)(D)).

62. *Id.* at 801 (codified at I.R.C. § 25A(c)(1)).

63. *Id.*

64. *Id.* (codified at I.R.C. § 25A(f)).

65. *Id.*

66. *Id.*

These educational credits are also phased out when a taxpayer's MAGI exceeds certain levels. If taxpayers file a joint return and have an MAGI above \$80,000, their credit begins to be phased out. When their income reaches \$100,000, the credit is completely phased out and is no longer available to them. Between these amounts, the credit is phased out in a pro rata manner.⁶⁸ For example, taxpayers filing a joint return with an MAGI of \$90,000 are entitled to take fifty percent of the credit that they would be entitled to had their income been less than \$80,000. This credit is phased out for all other taxpayers when their MAGI exceeds \$40,000 and is completely phased out when their MAGI reaches \$50,000.⁶⁹ The phase-out limits for both joint return filers and other filers are scheduled to be increased for inflation beginning in 2002.

Another tax benefit for those incurring educational expenses is a deduction for interest on qualified education loans.⁷⁰ This new deduction is an above-the-line deduction. That is, the taxpayer does not need to itemize in order to take advantage of this new deduction. Eventually, the maximum deduction allowed for interest on qualified educational loans will be \$2500; but this will be phased in over 4 years as follows: in 1998, the amount will be \$1000; in 1999, it will be \$1500; in 2000, it will be \$2000; and in 2000 and thereafter, it will be \$2500.⁷¹

This deduction is phased out for taxpayers with an MAGI between \$40,000 and \$55,000 (\$60,000 to \$75,000 for joint filers).⁷² Also, deductions for interest on educational loans are only allowed during the first sixty months that interest payments are required.⁷³

A qualified education loan includes any indebtedness incurred to pay qualified higher education expenses for the tax-

payer, taxpayer's spouse, or any dependent of the taxpayer.⁷⁴ Qualified higher education expenses include the cost of attendance at a qualified educational institution, but are reduced by the amount of any scholarship, allowance, or payment.⁷⁵

Another educational incentive is the broadening of the definition of what can be included in a state plan. Beginning in 1998, qualified state plans can include room and board.⁷⁶ Taxpayers can purchase room and board as part of a state tuition plan and obtain the same tax advantages that they receive for tuition. The advantages of investing in a qualified state tuition plan are numerous: contributions to the program are not treated as gifts; accrual of money in the program is not subject to income tax; and qualified distributions from the program are also not subject to tax.⁷⁷

Estate and Gift Taxes

Some final changes worth mentioning are in the area of estate and gift taxes. There is currently a \$10,000 exclusion for the gift of a present interest in property.⁷⁸ Beginning in 1999, the \$10,000 annual exclusion will increase with inflation; however, since it will only increase in \$1000 increments and inflation is currently below four percent, it most likely will not increase for several years.⁷⁹

Taxes on estates will also decrease. The lifetime credit currently allowed for estates is \$192,800.⁸⁰ This credit equals the amount of tax that would be charged to an estate valued at \$600,000. This credit will slowly increase so that by 2006 the credit will equal the amount of tax due on an estate valued at \$1,000,000.⁸¹ For 1998, the credit will increase to an amount which will equal the amount of tax due on an estate valued at \$625,000.⁸² Lieutenant Colonel Henderson.

67. *Id.* at 802 (codified at I.R.C. § 25A(g)).

68. *Id.* at 801 (codified at I.R.C. § 25A(d)).

69. *Id.*

70. *Id.* at 806 (codified at I.R.C. § 221).

71. *Id.* (codified at I.R.C. § 221(b)(1)).

72. *Id.* (codified at I.R.C. § 221(b)(2)).

73. *Id.* at 802 (codified at I.R.C. § 221(d)).

74. *Id.* (codified at I.R.C. § 221(e)(1)).

75. *Id.* (codified at I.R.C. § 221(e)(2)).

76. *Id.* at 810 (codified at I.R.C. § 529(e)(3)(B)).

77. *Id.* (codified at I.R.C. § 529(b)).

78. I.R.C. § 2503(b) (West 1997).

79. Pub. L. No. 105-34, § 501, 111 Stat. 788, 846 (codified at I.R.C. § 2503(b)).

80. I.R.C. § 2010(a).

Update for 1997 Federal Income Tax Returns

Legal assistance attorneys around the world who are preparing for the 1997 federal income tax filing season may find this update useful in publicizing the information that is of the most concern to military taxpayers.⁸³

Which Form Must Be Used?

The tax form that a taxpayer should use depends on his filing status, income level, and the type of deductions and credits he claims. The IRS has established the following guidelines for choosing tax forms:⁸⁴

* Use Form 1040EZ⁸⁵ if you meet the following conditions *during the tax year*: (1) you are single or married filing jointly; (2) you (and your spouse, if married) were under 65 on 1 January 1998; (3) you (and your spouse, if married) were not blind at the end of 1996; (4) you do not claim any dependents; (5) your taxable income is less than \$50,000; and (6) your taxable interest income was \$400 or less. If you use this form, you may not itemize deductions, claim credits, or take adjustments.

* Use Form 1040A⁸⁶ if your taxable income from wages, salaries, tips, interest, and dividends is less than \$50,000. If you use this form, you may not itemize deductions. You can claim credits and take adjustments.

* If you intend to itemize deductions, have any capital gains, or have gross income over \$50,000, you must use Form 1040.⁸⁷

When to File?

Tax returns must be postmarked by 15 April 1998.⁸⁸ Taxpayers who are living outside the United States and Puerto Rico on 15 April 1998 have until 15 June 1998 to file their returns.⁸⁹ If a taxpayer owes the IRS money, however, he will have to pay interest on the amount he owes from 15 April 1998 until the IRS receives his payment.⁹⁰ Taxpayers who are living outside the United States and Puerto Rico and want to take advantage of this extension should indicate on either their returns or an attached statement that they were overseas on 15 April 1998.

Taxpayers who served in a combat zone⁹¹ or a qualified hazardous area⁹² have at least 180 days from the time they left the combat zone in which to file their returns.⁹³ If a taxpayer was

81. Pub. L. No. 105-34, § 501, 111 Stat. 788, 845 (codified at I.R.C. § 2010(c)).

82. *Id.* The exclusion amount that the credit will equal is as follows:

In the case of estates dying,
and gifts made during:

1998	\$625,000
1999	\$650,000
2000 and 2001	\$675,000
2002 and 2003	\$700,000
2004	\$850,000
2005	\$950,000
2006 or thereafter	\$1,000,000

83. This update will be included in JA 269, *Tax Information Series*, a handbook of tax information flyers published each January by The Judge Advocate General's School, U.S. Army. This publication contains a series of camera-ready tax information handouts that may be reproduced for use in local preventive law programs. This update is currently in Microsoft Word format on the Bulletin Board of the Legal Automation Army-Wide System as JA269.DOC. The 1997 edition of JA 269 will be uploaded before the end of December 1997.

84. These guidelines are contained in the instructions to the various forms discussed in this section.

85. U.S. Internal Revenue Serv., Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents (1997).

86. U.S. Internal Revenue Serv., Form 1040A, Income Tax Return for Single and Joint Filers (1997).

87. U.S. Internal Revenue Serv., Form 1040, Income Tax Return for Single and Joint Filers (1997).

88. I.R.C. §§ 6072, 7502 (West 1997).

89. Treas. Reg. § 1.6081-5 (1990).

90. I.R.C. § 6601.

91. *Id.* § 112(c)(2). The only areas qualifying for combat zone treatment as of 1 October 1997 were the Arabian Peninsula areas, which include the Persian Gulf, the Red Sea, the Gulf of Oman, that portion of the Arabian Sea that lies north of 10 degrees north latitude and west of 68 degrees east longitude, the Gulf of Aden, and the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates. See Exec. Order No. 12,744, 1991-1 C.B. 31 (1991).

deployed outside the United States and away from his normal duty station in support of Operation Joint Endeavor or Operation Joint Guard, he is also entitled to this extension, even if he did not serve in the qualified hazardous duty area. No interest or penalties for failure to file or failure to pay will be assessed during this extension.⁹⁴

Taxpayers who do not qualify for the overseas or combat zone extension can still obtain an extension. First, a taxpayer can receive an extension to 15 August 1998 by filing Form 4868 no later than 15 April 1998.⁹⁵ Although this gives an automatic extension to 15 August 1998, the taxpayer must still pay any taxes owed by 15 April 1998. If he does not pay all taxes owed by 15 April, he will be subject to a "failure to pay" penalty and will be charged interest on any taxes not paid.

Taxpayers may also receive an additional two-month extension to 15 October 1998 by filing Form 2688.⁹⁶ This request for an additional extension will only be approved if the taxpayer can show good cause. The taxpayer will also be subject to a "failure to pay" penalty and interest charges if he does not pay his taxes in full by 15 April 1998.

What Are the 1997 Tax Rates?

The tax rates for 1997 remain unchanged and are 15%, 28%, 31%, 36%, and 39.6%. The following tables⁹⁷ show the adjusted tax rates by filing status for 1997:

Married Individuals Filing Joint Returns and Surviving Spouses

<u>If Taxable Income Is:</u>	<u>The Tax Is:</u>
Not Over \$41,200	15% of the taxable income
Over \$41,200 but not over \$99,600	\$6180 plus 28% of the excess over \$41,200
Over \$99,600 but not over \$151,750	\$22,532 plus 31% of the excess over \$99,600
Over \$151,750 but not over \$271,050	\$38,698.50 plus 36% of the excess over \$151,750

Over \$271,050	\$81,646.50 plus 39.6% of the excess over \$271,050
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Heads of Household

<u>If Taxable Income Is:</u>	<u>The Tax Is:</u>
Not Over \$33,050	15% of the taxable income
Over \$33,050 but not over \$85,350	\$4857.50 plus 28% of the excess over \$33,050
Over \$85,350 but not over \$138,200	\$19,601.50 plus 31% of the excess over \$85,350
Over \$138,200 but not over \$271,050	\$35,985 plus 36% of the excess over \$138,200
Over \$271,050	\$83,811 plus 39.6% of the excess over \$271,050

Unmarried Individuals (Other Than Surviving Spouses and Heads of Households)

<u>If Taxable Income Is:</u>	<u>The Tax Is:</u>
Not Over \$24,650	15% of the taxable income
Over \$24,650 but not over \$59,750	\$3697.50 plus 28% of the excess over \$24,650
Over \$59,750 but not over \$124,650	\$13,525.50 plus 31% of the excess over \$59,750
Over \$124,650 but not over \$271,050	\$33,644.50 plus 36% of the excess over \$124,650
Over \$271,050	\$86,348.50 plus 39.6% of the excess over \$271,050

Married Individuals Filing Separate Returns

92. Tax Benefits for Servicemen in Bosnia and Herzegovina, Pub. L. No. 104-117, § 1, 109 Stat. 827 (1996). Bosnia, Herzegovina, Croatia, and Macedonia are currently considered to be qualified hazardous duty areas. Also, taxpayers who performed services outside the United States as part of Operation Joint Endeavor or Operation Joint Guard and were away from their permanent duty stations are considered to have served in a hazardous duty area.

93. I.R.C. § 7508.

94. *Id.*

95. Temp. Treas. Reg. § 6081-4T (1996).

96. Treas. Reg. § 6081-1 (1989).

97. Rev. Proc. 96-59, 1996-2 C.B.

<u>If Taxable Income Is:</u>	<u>The Tax Is:</u>		
Not Over \$20,600	15% of the taxable income	Head of Household	\$6050
Over \$20,600 but not over \$49,800	\$3090 plus 28% of the excess over \$20,600	Unmarried Individuals (other than surviving spouses and heads of household)	\$4150
Over \$49,800 but not over \$75,875	\$11,266 plus 31% of the excess over \$49,800	Married Individuals Filing a Separate Return	\$3450
Over \$75,875 but not over \$135,525	\$19,349.25 plus 36% of the excess over \$75,875		
Over \$135,525	\$40,823.25 plus 39.6% of the excess over \$135,525		

Estates and Trusts

<u>If Taxable Income Is:</u>	<u>The Tax Is:</u>
Not Over \$1650	15% of the taxable income
Over \$1650 but not over \$3900	\$247.50 plus 28% of the excess over \$1650
Over \$3900 but not over \$5950	\$877.50 plus 31% of the excess over \$3900
Over \$5950 but not over \$8100	\$1513 plus 36% of the excess over \$5950
Over \$8100	\$2287 plus 39.6% of the excess over \$8100

The IRS allows the elderly and the blind to claim a higher standard deduction.⁹⁹ A minor child claimed as a dependent on another taxpayer's return is entitled to a standard deduction, and that standard deduction is limited to the greater of \$650 or the child's earned income.¹⁰⁰ Thus, if a minor child did not work and had only investment income, the child would take a standard deduction of \$650. If the child worked and had income of \$2500, the child would take a standard deduction of \$2500. The child's standard deduction would never exceed the standard deduction for a similar taxpayer.¹⁰¹ Thus, if the child were unmarried and earned \$5000, the child would take a standard deduction of \$4150.

What Is the 1997 Personal Exemption?

The personal exemption amount has increased to \$2650 for 1997.¹⁰² Social security numbers are required for all dependents claimed on a tax return. The personal exemption begins to phase out at \$181,800 for taxpayers filing a joint return; \$151,500 for heads of household; \$121,200 for unmarried taxpayers (other than surviving spouses or heads of household); and \$90,900 for taxpayers who are married and filing separately.¹⁰³

What Are the 1997 Standard Deductions?

Earned Income Credit

The following table shows the standard deduction⁹⁸ amounts for 1997:

<u>Filing Status</u>	<u>Standard Deduction</u>
Joint Returns and Surviving Spouses	\$6900

The earned income credit will again be available. Taxpayers will be eligible if their adjusted gross income is less than \$9770 and they have no children; \$25,760 and they have one child; or \$29,290 and they have two or more children.¹⁰⁴ Lieutenant Colonel Henderson.

98. *Id.*

99. I.R.C. § 63(c)(3) (West 1997).

100. *Id.* § 63(c)(5).

101. *Id.* § 63(c)(2).

102. Rev. Proc. 96-59, 1996-2 C.B.

103. *Id.*

104. *Id.*

Contract Law Note

Federal Circuits Split on Application of the Major Fraud Act to Government Contracts

*"A little neglect may breed mischief, . . . for want of a nail, the shoe was lost; for want of a shoe the horse was lost; and for want of a horse the rider was lost."*¹⁰⁵

—Benjamin Franklin

In *United States v. Brooks*,¹⁰⁶ the United States Court of Appeals for the Fourth Circuit recently held that the one million dollar jurisdictional threshold of the Major Fraud Act¹⁰⁷ is satisfied when a prime contract is valued at one million dollars or more, regardless of the value of the particular subcontract which was tainted with fraud. This holding is contrary to the Second Circuit's opinion in *United States v. Nadi*.¹⁰⁸ In *Nadi*, the court specifically held that the value of the contract, for jurisdictional purposes under the Major Fraud Act, is determined by the value of the contract upon which the actual fraud is based.¹⁰⁹ This conflict between the federal circuits creates a certain amount of ambiguity for the practitioner who must

decide whether to pursue a particular contractor under the Major Fraud Act.

The facts in *Brooks* are rather straightforward. Edwin, John, and Stephen Brooks operated B & D Electric Supply, Inc. (B&D).¹¹⁰ The company sold electrical supplies to both military and civilian customers.¹¹¹ The fraud committed by B&D involved two subcontracts that it held with firms that had entered into prime contracts with the U. S. Navy.¹¹² The first subcontract was with Jonathan Corporation for fourteen shipboard motor controls for a total price of \$51,544.¹¹³ The prime contract between Jonathan Corporation and the Navy was valued at approximately nine million dollars.¹¹⁴ The second subcontract was with Ingalls Shipbuilding, Inc. (Ingalls) for six rotary switches for a total price of \$1470.¹¹⁵ The value of Ingalls' prime contract with the Navy was five million dollars.¹¹⁶ As a result of fraud in the performance of the subcontracts, B & D was convicted in the United States District Court for the Eastern District of Virginia for, among other things, violations of the Major Fraud Act.¹¹⁷

On appeal to the Fourth Circuit, B&D challenged the district court's interpretation of the Major Fraud Act.¹¹⁸ It argued that the value of the contract under which the Major Fraud Act is triggered should be determined by looking at the value of the

105. OXFORD DICTIONARY OF QUOTATIONS (Oxford Univ. Press 1979), quoting BENJAMIN FRANKLIN, POOR RICHARD'S ALMANAC (1758).

106. 111 F.3d 365 (4th Cir. 1997).

107. 18 U.S.C. § 1031(a) (1994). The statute provides:

Whoever knowingly executes, or attempts to execute, any scheme or artifice with the intent (1) to defraud the United States, or (2) to obtain money or property by means of false or fraudulent pretenses, representations, or promises, in any procurement of property or services as a prime contractor with the United States or as a subcontractor or supplier on a contract in which there is a prime contract with the United States, if the value of the contract, subcontract, or any constituent part thereof, for such property or services is \$1,000,000 or more, shall, subject to the applicability of subsection (c), be fined not more than \$1,000,000, or imprisoned not more than 10 years or both.

Id. (emphasis added).

108. 996 F.2d 548 (2d Cir. 1993).

109. *Id.* at 551.

110. *Brooks*, 111 F.3d at 368.

111. *Id.* The majority of B&D's business involved reselling new components produced by well-known and well-established manufacturers of electrical components. Under some limited circumstances, B&D sold certain electrical components that it custom-assembled. *Id.*

112. *Id.*

113. *Id.* In this contract, B&D assembled the controllers itself, but it attempted to mislead the Navy by affixing to the controllers the trademarks of Cutler-Hammer Company, an approved military supplier of controllers. *Id.*

114. *Id.*

115. *Id.* In this contract, B&D attempted to mislead the Navy by representing that the switches were new when B&D actually had only assembled or rebuilt them. *Id.*

116. *Id.*

117. *Id.* at 365.

118. *Id.* at 368.

specific contract upon which the fraud is based. Thus, B&D contended that the fraudulent misconduct involved subcontracts which were only valued at \$51,544 and \$1470 respectively.¹¹⁹ Accordingly, B&D argued that the fraudulent conduct did not fall within the Major Fraud Act's jurisdictional amount of one million dollars.¹²⁰

The Fourth Circuit disagreed. The court stated that any contractor or supplier involved with a prime contract with the United States who commits fraud is guilty so long as the prime contract or subcontract is valued at more than one million dollars, regardless of privity with the United States.¹²¹ The court specifically stated:

This reading [of the Major Fraud Act] recognizes that the seriousness of this species of fraud is measured not merely by the out-of-pocket financial loss incurred on a particular subcontract, but also by the potential consequences of the fraud for persons and property. In military contracts in particular, fraud in the provision of small and inexpensive parts can have major effects, destroying or making inoperable multi-million dollar systems or equipment, injuring service people, and compromising military readiness. By extending the statute's coverage even to minor contractors and suppliers whose fraudulent actions could undermine major opera-

tions, Congress enabled prosecutors to combat effectively the severe procurement fraud problem that Congress identified.¹²²

The Fourth Circuit explicitly recognized that its decision was contrary to the position taken by the Second Circuit in *United States v. Nadi*.¹²³

In *Nadi*, the Department of Defense awarded two contracts in 1990 and 1991 to supply packaged salt and pepper to American troops in the Persian Gulf War. One contract (for packaged salt) was for \$426,000, and the other contract (for packaged pepper) was for \$1,074,000.¹²⁴ The contracts were awarded to Robbins Sales Company,¹²⁵ which subcontracted the work to My Brands, a condiment packager based in Bronx, New York. My Brands was the only subcontractor and performed all of the contract work.¹²⁶ In order to produce large amounts of salt and pepper, My Brands expanded its plant capacity and entered into an agreement with a vendor to purchase five condiment packing machines at \$50,000.¹²⁷ My Brands only received four of the machines and paid for only two of them.¹²⁸ After the Persian Gulf War ended, the Department of Defense terminated the contracts for convenience.¹²⁹ My Brands subsequently submitted a false claim seeking reimbursement for all five machines at \$115,000 each, more than double the sales value of the equipment.¹³⁰ The contractor was convicted in the United States District Court for the Southern District of New York for, among other things, violations of the Major Fraud Act.¹³¹

119. *Id.*

120. 18 U.S.C. § 1031(a) (1994).

121. *Brooks*, 111 F.3d at 369. In addition to the specific language of Section 1031(a), the court explored the legislative history underpinning the statute. The court quoted at length from the senate report, which stated:

Procurement fraud is the most costly kind of fraud, accounting for about 18% of total losses. The Department of Defense reports losses of \$99.1 million due to procurement fraud for fiscal years 1986 and 1987. Prosecutions of individual companies reveal other disturbing facts: Two corporate officials of Spring Works, Inc. were convicted of deliberately providing defective springs for installation in critical assemblies of the CH-47 helicopters, the Cruise Missile, and the F-18 and B-1 aircraft. Two corporate officials of MKB Manufacturing were sentenced for their role in the deliberate provision of defective gas pistons for installation in the M60 machine gun. Installation of the defective part would cause the gun to jam. Thus, the evidence shows that, besides causing financial losses, procurement fraud could cost the life of American soldiers and could threaten national security. These facts compel a legislative solution.

S. REP. NO. 100-503, at 2 (1988).

122. *Brooks*, 111 F.3d at 369.

123. 996 F.2d 548 (2d Cir. 1993).

124. *Id.* at 548-49.

125. *Id.* at 549. Robbins was a broker with no production capacity of its own.

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* Under the contracts, the Department of Defense had the right to terminate performance unilaterally. In the event of the termination, the contractor had the corresponding right to claim reimbursement for actual "out-of-pocket" expenses. *Id.*

On appeal, My Brands claimed that the Major Fraud Act did not define “value of the contract” and thus created a “trap for the unwary and permits arbitrary enforcement.”¹³² The court disagreed with My Brands, noting that the common sense interpretation of “value of the contract” is confirmed by the statute’s legislative history: “[t]he phrase ‘value of the contract’ refers to the value of the contract award or the amount the government has agreed to pay to the provider of services whether or not this sum represents a profit to the contracting company.”¹³³

In dicta, however, the *Nadi* court stated:

Nonetheless, we find that a reasonable reading of the statute, in light of the legislative history, requires that we adopt the rule, argued for by Defendants, whereby the value of the contract is determined by looking to the specific contract upon which the fraud is based. *So, for example, in a case where the value of a subcontract is less than \$1,000,000 but the prime contract is for \$1,000,000 or more, the subcontractor would escape liability under section 1031.* We adopt this rule with reference to the language of the statute.¹³⁴

Thus, the court in *Nadi* believed the focus should be on the specific contract that was tainted with fraud.

For the practitioner, it is virtually impossible to reconcile the contrary positions taken by the Fourth and Second Circuits. The application of the Major Fraud Act by the two circuits was not fact-dependent; it was simply a matter of statutory interpre-

tation. The more expansive reading of the Major Fraud Act by the Fourth Circuit is more beneficial to the government. In justification, the Fourth Circuit summed up its position by stating, in part:

But the jurisdictional amount requirement of the major fraud statute, like any bright line rule, dictates that some cases will fall outside the scope of the law. We believe that our reading of the statute is no more anomalous than one which allows small subcontractors to escape prosecution under the provision, regardless of the overall project which their fraud affects, simply by ensuring that their own subcontract stays below the \$1 million jurisdictional amount. The *Nadi* court’s interpretation could significantly undermine the purpose of the statute because pervasive fraud on a multi-million dollar defense project would be unreachable under the statute, despite Congress’ intent, if it were perpetrated in multiple separate subcontracts, each involving less than the jurisdictional amount.¹³⁵

In deciding what cause of action to pursue, the practitioner should recognize that there is a split of authority between the circuits. The United States Supreme Court will be the ultimate arbiter of how 18 U.S.C. § 1031(a) will be interpreted. Until such time, *United States v. Brooks*¹³⁶ provides an aggressive approach to ferret out fraudulent conduct by subcontractors on government contracts. Major Wallace.

130. *Id.* The contractor asked the vendor who sold the condiment machines (Suffolk Mechanical, Inc.) to issue false billing statements reflecting the price of the machines at \$115,000 each. *Id.*

131. *Id.* at 548.

132. *Id.* at 550.

133. S. REP. NO. 100-503, at 12 (1988).

134. *Nadi*, 996 F.2d at 551 (emphasis added).

135. *United States v. Brooks*, 111 F.3d 365, 369 (4th Cir. 1997).

136. *Id.* at 368.